Insurance Institute of Michigan

The Use of Credit In Home and Auto Insurance Discounts

What does credit have to do with auto and home insurance? How do consumers benefit from the use of credit-based insurance scoring in insurance?

The use of credit-based insurance scores is a benefit to insurance customers. Credit-based insurance scoring helps more accurately price insurance based on a consumer's claim potential. As a result of credit-based insurance scoring, many consumers pay less for insurance than they otherwise would, and enables insurance companies to offer coverage to more consumers than they had in the past.

In July of 2007 after years of extensive research, the Federal Trade Commission (FTC) found that use of credit-based insurance scores leads to more accurate underwriting of auto insurance policies in that there is a correlation between insurance scores and the likelihood of filing an insurance claim.

The FTC report, *Credit Based Insurance Scores: Impacts on Consumers of Automobile Insurance*, also states that credit-based insurance scores cannot easily be used as a proxy for race and ethnic origin. In other words, credit-based insurance scoring predicted risk for members of minority groups in much the same way that it predicted risk for members of non-minority groups.

Items in a person's credit history provide a consistent and effective tool to evaluate risk that does not discriminate against any specific group of customers. In fact, the use of credit-based insurance scores actually allows insurance companies to offer lower rates by providing discounts to consumers who have proven to manage their finances well. In Michigan, two-thirds of policyholders receive significantly lower rates due to credit-based insurance scoring.

Credit-based insurance scores are developed from information contained in credit reports. A credit-based insurance score provides a numeric assessment of an individual's insurance risk. It reflects credit payment patterns, length of credit history, types of credit and number of new applications for credit. Insurance companies consider only those items from credit reports that are relevant to insurance loss potential. Unlike a lender, an insurance company is not assessing a customer's income and debt, they are evaluating how customers manage their finances and credit granted to them.

Key findings of the FTC study are:

- Credit-based insurance scores are effective predictors of risk under automobile policies. They are predictive of the number of claims consumers file and the total cost of those claims. The use of scores is therefore likely to make the price of insurance better match the risk of loss posed by the consumer. Thus, on average, higher-risk consumers will pay higher premiums and lower-risk consumers will pay lower premiums.

- Several alternative explanations for the source of the correlation between credit-based insurance scores and risk have been suggested. At this time, there is not sufficient evidence to judge which of these explanations, if any, is correct.

- Use of credit-based insurance scores may result in benefits for consumers. For example, scores permit insurance companies to evaluate risk with greater accuracy, which may make them more willing to offer insurance to higher-risk consumers for whom they would otherwise not be able to determine an appropriate premium. Scores also may make the process of granting and pricing insurance quicker and cheaper, cost savings that may be passed on to consumers in the form of lower premiums. However, little hard data was submitted or available to quantify the magnitude of these benefits to consumers.

- Credit-based insurance scores appear to have little effect as a "proxy" for membership in racial and ethnic groups in decisions related to insurance.

In Michigan, the Commissioner of the Office of Financial and Insurance Regulation (OFIR), the state regulator of insurance, sought to implement a rule that would ban the use of credit-based insurance scoring in this state. That rule was challenged by the insurance industry. A circuit court judge ruled that OFIR did not have the authority to ban credit scoring through administrative rule. However, the Michigan Court of Appeals reversed that decision. The Court of Appeals decision is being appealed to the Michigan Supreme Court. It is important to note that during the legal appeal process, companies can continue to use credit-based insurance scores as a rating factor.

Prohibiting the use of credit-based insurance scoring will have a detrimental impact on those policyholders receiving significant discounts in Michigan. In Maryland, policyholders faced double-digit percentage increases in their homeowners insurance because of a 2002 state law that banned the use of insurance credit scoring.

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Q & A ABOUT THE USE OF INSURANCE CREDIT SCORE DISCOUNTS IN MICHIGAN

What does a person's credit have to do with home and auto insurance?

Independent studies have proven a strong connection between certain factors in an individual's credit history and the likelihood of an individual filing a claim. People who use credit wisely are generally responsible in other areas of their lives. Research indicates that people with better credit-based insurance scores have fewer losses and less expensive claims.

What is a credit-based insurance score discount?

Credit-based insurance scores are different from credit reports or scores used by lenders. Insurance companies develop credit-based insurance scores from certain credit history information contained in credit bureau reports and use the information when making rating decisions. A credit-based insurance score provides a numeric assessment of an individual's credit risk. It reflects credit payment patterns, outstanding debt, length of credit history, types of credit and number of new applications for credit. Insurance companies consider only those items from credit reports that are relevant to insurance loss potential. Unlike a lender, an insurance company is not assessing a customer's income and debt, they are evaluating how customers manage their finances and credit granted to them.

Why do insurance companies use credit history in rating decision making?

To make fair and objective underwriting decisions, insurance companies need to have as much information as possible. Items in a person's credit history provide a consistent and effective tool to evaluate risk that does not discriminate against any specific group of customers. Information such as a person's age, income, ethnic group, religion, gender or marital status is not factored into credit-based insurance scores.

Why don't insurance companies just look at driving records or claims history?

Most people think that insurance companies can obtain all the information they need from state motor vehicle departments. However, a study by the Insurance Research Council (IRC) indicated that one in five traffic violations may not appear on a Motor Vehicle Record (MVR). Credit information is generally more accurate and compliments driving history to work to the advantage of most policyholders.

How does the use of credit-based insurance score discount benefit insurance consumers?

The use of credit-based insurance scores actually allows insurance companies to offer lower rates by providing discounts to consumers who have proven to responsibly manage their finances. Two-thirds of policyholders have a significantly lower premium because of good credit.

What would happen if insurance companies could no longer provide a discount based on credit information?

If credit information is no longer used as a factor for discounts, many consumers who have a lower potential for loss would pay more for insurance.

Do all insurance companies use credit-based insurance scoring in their rate making?

Most insurance companies do use insurance credit-based insurance scoring. However, consumers can access a list of insurance companies that do and don't use insurance credit scoring at the the Michigan Office of Financial and Insurance Regulation website, *www.michigan.gov/ofis.*

Can a consumer be denied insurance based on their insurance credit-based insurance score?

In Michigan, state law prohibits consumers from being refused insurance based on their credit-based insurance score. Insurance companies here may, however, offer a discount for good insurance credit.

How is a consumer's privacy protected?

Access to specific credit information is very limited. Most insurance companies only see the score, not the information that went into developing it. All companies must follow the Fair Credit Reporting Act and state laws that apply to the use of credit information. These measures ensure there is confidentiality, accuracy and a legitimate need for the information.

Aren't credit reports notoriously inaccurate?

The Consumer Data Industry Association reports that less than 1 percent of all credit report challenges result in a change once the inquiry has been fully investigated. Studies have found that credit reports are more reliable than motor vehicle records.

How can consumers find out about their credit-based insurance score discount?

The use of credit information is not secret. Every existing and potential policyholder deserves to know how a company uses credit information. If you don't feel your agent or company is telling you what you need to know, shop around for another agent or company that will.

What can consumers do to improve their insurance credit-based insurance score?

Consumers can improve their credit-based insurance scores over time by using credit responsibly. Make sure you pay bills on time, keep balances low and apply for and open new credit accounts only as needed.

It is also a good idea to periodically obtain a copy of your credit reports from the three major credit bureaus to check for any inaccuracies. These are available free once a year by visiting, *www.annualcreditreport.com* or calling 1-877-322-8228.

Can consumers ask to have their credit score recalculated if they improve their credit score?

Yes. At the request of the policyholder, a company will rescore at least once annually.

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